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CRITERIA FOR EVALUATING DAIRY COOPERATIVES

By

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FARMER COOPERATIVE SERVICE
U.S. DEPARTMENT OF AGRICULTURE

The Farmer Cooperative Service conducts research studies and service activities of assistance to farmers in connection with cooperatives engaged in marketing farm products, purchasing farm supplies, and supplying business services. The work of the Service relates to problems of management, organization, policies, merchandising, product quality, costs, efficiency, financing, and membership.

The Service publishes the results of such studies; confers and advises with officials of farmer cooperatives; and works with educational agencies, cooperatives, and others in the dissemination of information relating to cooperative principles and practices.

Joseph G. Knapp
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U.S. Department of Agriculture

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PREFACE

LEADERS of dairy cooperatives, educational and advisory workers, and administrators of Government programs long have needed a basis for distinguishing between a real (bona fide) and an imitation (pseudo) cooperative. This need culminated in a specific request to Farmer Cooperative Service to conduct research and develop criteria for identifying farmers' dairy cooperatives.

This report provides a set of criteria designed for use in appraising dairy organizations to determine

whether they meet acceptable standards as cooperatives. It is not directly concerned with physical facilities or operating procedures in milk assembly, processing, and distribution. The criteria look to the future in terms of appraising the competence of the associations to represent and serve the interests of dairy farmers under anticipated market conditions.

We searched several sources to determine the identifying characteristics of genuine dairy cooperatives. We reviewed laws and legislative

hearings for the legal standards that apply to cooperatives, and to understand the thinking of legislators who drew up the laws. We studied a large body of research reports, periodicals, and other statements concerning the economic and legal character as well as the history and development of cooperatives. We discussed with administrative officials the problems of identifying cooperatives. Finally, in sifting and evaluating this material, we were guided by our experience and that of others in working with dairy and other cooperatives nationally.

We realized at the outset of our research that we could not develop a single, terse definition which would identify a cooperative; that discrimination and judgment on the part of the appraiser would be required. The accuracy and significance of this premise became clearer as research progressed. Many of our attempts to provide categorical and completely objective statements were reduced to generalities that did not suffice to identify marketing organizations that serve and directly benefit farmers.

The first section of this report reviews the current position of dairy cooperatives in the industry and the changing technical and economic environment in which they operate. The section "What Is a Cooperative?" includes basic legal standards and general statements by qualified observers concerning the legal and economic character of cooperatives. It identifies three "hard core" principles—service to members at cost, democratic control by member-patrons, and limited returns on capital—and also supplementary characteristics.

The section "Determining Cooperative Character of Dairy Organizations" provides a set of standards

for identifying a dairy cooperative. These standards fall under three headings: (1) Marketing Service for Members, (2) Control by Member-Patrons, and (3) Sound Business Practices. Each of these standards is discussed and explained.

The standards may be condensed into questionnaire form for use with a specific cooperative. However, effective appraisal is complex, calling on judgment and insight rather than principally clerical skills.

We believe the fundamental and initial need is for standards that may be applied by rank-and-file producer-members and leaders themselves. An alert and informed membership can do more than any reasonable amount of outside administrative interpretations or regulations to assure and maintain the cooperative character of an organization.

Because of differences in the purposes and provisions of laws applicable to individual programs, State or Federal agencies seeking administrative standards for identifying dairy cooperatives may need to adapt or supplement those presented here to suit their specific needs. For example, the purposes and needs of the Federal milk order program and the Farm Credit Administration are different. In some cases, agencies may require clarification of their legislative authorizations before they are able to tighten their current standards.

We again emphasize that discrimination and judgment are of the utmost importance in applying the criteria in every case. Otherwise, they will be no more than a bare skeleton and their use will not assure dairy farmers of an organization that serves them in a unique way because it meets the true standards of a cooperative.

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Criteria for Evaluating Dairy Cooperatives

by

Stanley F. Krause and Joseph M. Cowden
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THIS report considers the adequacy of organization and administration of present dairy cooperatives and whether they will truly be able to serve future needs of producers, the industry, and the national economy.

We begin with an organization seeking to be recognized as a cooperative, and undertake to determine whether or to what extent it meets acceptable standards and will continue to meet them.

The key question, as we see it, is: Assuming that organizational adjustment will be necessary to facilitate technical change—what can be done to assure that dairy organizations, given recognition as cooperatives, have and will retain distinctive cooperative characteristics? This question is highly important because—

1. Dairy cooperatives have contributed much to the welfare of dairy producers.

2. The cooperative segment at present constitutes a highly significant part of the dairy industry.

3. Cooperatives will be needed to represent producer interests in

marketing dairy products in the future.

4. Dairy cooperatives, like other market agencies, will be forced to make major adjustments in response to changing conditions.

5. There is danger that the cooperative character of dairy cooperatives will be lost in the process of adjustment unless steps are taken to prevent such loss.

6. Producer interests will continue to require the services of business organizations having distinctively cooperative characteristics.

It should be noted that in wording our question concerning the future, we did not say "will retain *present* distinctive characteristics." Neither the cooperative leaders who posed this question nor we in Farmer Cooperative Service believe that cooperative principles, fundamentals, and policies, or the practices appropriate for them, are static. The characteristics distinguishing future dairy cooperatives from other dairy firms may or may not be the same as they are today.

Establishing specific criteria for cooperatives may lead to several

NOTE.—The initial research in this study was undertaken and the preliminary manuscript prepared by Joseph M. Cowden while he was a member of the staff of Farmer Cooperative Service. The manuscript was completed by Stanley F. Krause. The authors are indebted to the persons who reviewed the draft manuscript and made numerous valuable suggestions.

benefits. The first concerns improvement of the marketing system. The cooperative is a special type of organization under farmer control and members need definite guides concerning the features that will obtain maximum benefits for them.

Two other benefits come from helping prevent deception of farmers and the public, respectively. A cooperative should be identified so that farmers will not support and falsely trust an organization not fully devoted to their interest. They need to know what to look for in an organization to appraise the likelihood that it will function in their interest—or to direct that appropriate changes be made.

The public image of cooperatives may be discolored by organizations which use the farmer cooperative name but do not serve members' interests or which depart from other

distinctive practices of cooperatives. Finally, organizations other than cooperatives should not be permitted to take advantage of any legal authority reserved for organizations controlled and operated by and for their member-patrons.

Our purpose is to assist those interested in determining the *cooperative* character of organizations by directing attention to their distinctive features. We have also endeavored to indicate characteristics of cooperative organizations which may be subjected to unusual stress in the years ahead. A policy of regular inspection and sound maintenance by its own member-leaders will be required, we believe, to keep a cooperative functioning properly.

Public administrators need to inspect cooperatives for any purposes that relate specifically and distinctly to them.

The Current Situation

BEFORE proceeding to the main problem, it will be helpful to review the position dairy cooperatives now occupy in the industry and the changing technical and economic environment for dairy marketing.

Dairy cooperatives play an important role in marketing milk and cream produced on farms in the United States. Data compiled by Farmer Cooperative Service showed that dairy cooperatives performed one or more functions in marketing 58 billion pounds of whole milk in 1957.¹ This quantity represented

approximately 60 percent of all whole milk sold through plants and dealers in the United States that year. In addition, cooperatives handled 189 million pounds of butterfat in cream, or 43 percent of the total handled by all plants and dealers.

Changing Environment

Dairy cooperatives attained much of this prominent position under conditions significantly different from those existing today. Widespread changes are taking place in the market for milk and dairy products, both in supply and distribution.

The dairy farm as a production unit is getting larger and more spe-

¹ Gessner, Anne L. *Integrated Dairy Operations Through Farmer Cooperatives*. Gen. Rpt. 69, p. iii. Farmer Cooperative Service, U.S. Dept. of Agr., November 1959.

cialized. Mechanization of many operations is well advanced on commercial dairy farms. Because the individual dairy farmer has more at stake, he should be more interested in the efficient functioning of his dairy cooperative than he was in the past.

Markets for milk are changing. Once local, milk markets are now essentially regional or national in character. Improved management practices and mechanization help the dairyman produce high-quality milk. Bulk cooling and storage facilitate the transportation of raw milk over greater distances without loss of quality. Dairy men can thus seek outlets in the higher quality, higher priced, fluid milk markets.

In many areas the industry has tooled up to process whole milk instead of the farm-separated cream formerly handled by most creameries. The dairy manufacturing industry has been moving toward larger, lower cost plants, as research and experience have demonstrated that a well-managed, large-volume plant has a considerable advantage over smaller plants.

As a result of such changes, many small local manufacturing dairy cooperatives find themselves with facilities they no longer need. Many such facilities are neither equipped nor located to serve the best interests of member-producers. Mergers, consolidation, and integration, and frequent outright failures of marketing concerns have brought about a steady decrease in the number of plants and firms manufacturing dairy products.

Cooperatives functioning in fluid milk markets face similar changes. Country can-receiving plants are being bypassed and replaced by bulk handling plants. These are fewer in number and each serves



Through their cooperatives, farmers marketed about three-fifths of the milk going to plants and dealers in 1957.

an expanded area. Improved transportation, packaging milk in paper cartons, and the economies of large-scale processing encourage and enable the milk distributor to serve enlarged consumption areas from centrally located bottling plants.

Chain stores which demand regular supplies of uniform quality products in large lots tend to dominate the retail business. In most of the large markets, affiliates of one or more of the national dairy firms occupy a prominent, if not dominant, position in processing and distributing fluid milk products. Cooperatives selling fluid milk thus face increasing concentration of bargaining power on the part of processors, distributors, and retailers.

Dairy Cooperatives Are Changing

It is clear that dairy cooperatives cannot stand still and maintain their place in the economy. They

must be prepared to continue to change in the future.

Many cooperatives which formerly performed only bargaining functions find it necessary to operate manufacturing plants to provide a market for milk in excess of fluid requirements and to perform other marketing services.



Another development of great importance to cooperatives is the widespread adoption of Federal milk marketing orders. By 1961, these programs were in effect in 80 markets, including most of our large cities. The functions of dairy cooperatives and Federal order programs are highly complementary to each other in today's markets.

In the 5-year period 1953-54 to 1958-59, the number of dairy cooperatives in operation decreased 14.5 percent, from 1,862 to 1,592. During the same period the reported membership of dairy cooperatives declined 14.6 percent.² The number of farms reporting

² Gessner, Anne L. *Statistics of Farmer Cooperatives 1953-54*. Gen. Rpt. 53, p. 18, Farmer Cooperative Service, U.S. Dept. of Agr., June 1956.

Gessner, Anne L. *Statistics of Farmer Cooperatives 1958-59*. Gen. Rept. 93, p. 7, Farmer Cooperative Service, U.S. Dept. of Agr., August 1961. (Alaska omitted in order to provide comparable data.)



Cooperatives must be alert to meet economic and technical developments. The change from rows of cans to stainless-steel tanks for bulk handling has had far-reaching effects.

sales of milk or cream fell 31 percent from 1954 to 1959. However, in spite of the reduction in number of cooperatives and members, the net dollar volume of dairy products marketed by cooperatives increased 23 percent.

The drop in membership of dairy cooperatives in recent years has been largely the result of factors others than the declining number of associations. The decrease in number of dairy farms is probably the principal cause. The downward trend in membership is expected to continue.

Dairy cooperatives, like the rest of the dairy industry, are making adjustments in response to or as the result of technical and economic changes. Although dairy cooperatives are adapting to new conditions in many ways, students of cooperative problems have seriously questioned whether they are doing so fast enough to maintain their

place in the industry. In order to improve their effectiveness, cooperatives must increase in size, adopt new business methods, and improve their marketing programs. In brief, a dairy cooperative is a business enterprise and it must make whatever changes are necessary to remain competitively strong.

If an ordinary business firm maintains its competitive position, it is a success. A firm organized as a cooperative, however, may make the adjustments necessary to meet competition but fail as a cooperative. The interests of dairy farmers will not be served most effectively unless dairy cooperatives of the future function as competitive *cooperative* businesses—not merely as competitive businesses. With this thought in mind, we proceed to a consideration of items to be examined in checking up on the “cooperative character” of dairy organizations.

What Is a Cooperative?

IN judging a dairy organization as a cooperative, as distinguished from other forms of business enterprise, we must evaluate primarily those characteristics which have withstood the test of time and have been accepted as cooperative principles. It is essential to emphasize the services performed, the ultimate source of decision making, and the distribution of benefits.

In its simplest form, the question which faces us is: “What is a cooperative?” or, “What is cooperation?”

We have not attempted to answer this question in the form of one terse definition. The definition ap-

proach alone is inadequate since the cooperative concept may be found in company with many outward forms that seem indistinguishable from other forms of business enterprise. Instead, we have drawn on the experience, ideas, and opinions of numerous students and writers in the field to point out the general features which serve to identify a cooperative organization.

To assist the reader further in reaching his own conclusion, we reviewed provisions of several Federal laws in respect to qualifications of cooperatives and, finally, we narrowed our discussion down to those features or principles of agricul-

tural cooperation which students of the subject generally consider to be basic.

General Nature

The authors of an earlier U.S. Department of Agriculture publication defined cooperation in these words: "Cooperation is organized working together for mutual benefit. Economic cooperation is a form of business with democratic ownership and control by member-patrons having common needs, serving themselves on a nonprofit basis, and receiving benefits proportional to participation."³

An official of a large cooperative referred to members of agricultural cooperatives as self-selected capitalists seeking to improve their individual economic positions. In his view, the members come together on the basis of self-interest and to deal with society as it is and not to reform it.⁴

Other writers have expressed these basic viewpoints in various ways. Henry H. Bakken and Marvin A. Schaars, in discussing the immediate purposes for which cooperatives are organized, say: "The purpose is, therefore, defined in economic terms; all social considerations are secondary."⁵ These authors indicate further that the "desire for pecuniary gain" is the

most common reason for which people join cooperatives.

Another cooperative leader puts the term "nonprofit," often used as a basic characteristic of cooperatives, in perspective thus: "Students of the cooperative movement point out that, although the cooperative operates on a nonprofit basis, the profit motive is behind the enterprise. As in a partnership, members establish cooperatives as a means of increasing the profits from their farm operations. Thus cooperative business is a rival and partner of commercial business in the American system of free enterprise."⁶

A recent publication of the Texas Agricultural Extension Service concisely defines a farmer cooperative as "... a group of agricultural producers incorporated to provide off-the-farm services for the members on a mutual nonprofit basis."⁷

Joseph G. Knapp, writing in *Harvard Business Review*,⁸ outlined the distinctive purposes of cooperatives as follows:

"1. They seek to obtain services for themselves at cost—not to obtain profit from rendering services to others.

"2. They try to render the greatest financial benefit to their members as users—not to maximize profit for owners as distinct from users.

³ *Farmer Cooperatives in the United States*. Bul. 1, p. 4. Farmer Cooperative Service, U.S. Dept. of Agr., December 1955.

⁴ Babcock, H. E. *Cooperatives the Pace Setters in Agriculture*. Journal of Farm Economics, Vol. XVII; No. 1, pp. 153-156. 1935.

⁵ Bakken, Henry H., and Schaars, Marvin A. *Economics of Cooperative Marketing*. Ed. 1, p. 6. McGraw-Hill Book Co. Inc. New York and London.

⁶ Stokdyk, E. A. *Co-ops Economic Objectives*. Cooperative Digest. Vol. 7, No. 2; p. 54. Roy H. Park, Inc., Ithaca, N.Y., August 1946.

⁷ Jaynes, M. C. *Handbook for Directors of Farmer Cooperatives B-170*. P. 28. Texas Agricultural Extension Service. College Station, Tex. 1949.

⁸ Knapp, Joseph G. *Are Cooperatives Good Business?* Harvard Business Review, p. 58. January-February 1957.

"3. They distribute amounts remaining, after payment of the costs of doing business, among those who are served by the cooperative in proportion to their use of its services—not in proportion to their investment in the enterprise.

"4. They plan to have an organization that will be controlled by its patron-members (each of whom ordinarily is allowed a single vote)—not by the owners in proportion to capital contributed."

By analyzing the definitions and descriptions just quoted, the reader can obtain a general conception of an agricultural cooperative organization. It will be noted that a cooperative is organized primarily as a business enterprise. It is owned and controlled by the people who use it. It is not socialistic but capitalistic and competitive—a part of a free enterprise system. It is "non-profit" to the extent that the cooperative as such makes only limited or no profits for itself or for its owners in their ownership relation, although the profit motive is a driving force among its member-patrons.

Are there additional characteristics which differentiate cooperatives from other forms of business organization? To answer this question, we will first examine descriptive provisions of some of the Federal statutes pertaining to agricultural cooperatives.

As Identified by Statutes

Agricultural cooperatives in the United States are incorporated under State laws. Laws providing for incorporation of agricultural associations in line with accepted cooperative principles are on the statute books of every State.



People are the heart of a cooperative. An annual meeting, such as pictured here, tells the story of a cooperative better than its buildings and equipment.

Neither State nor Federal laws invented the cooperative institution nor established the principles of cooperation. Rather, the principles and most of the practices preceded the laws.⁹ Legislation guides the appropriate application of certain administrative functions and regulatory programs to the distinct cooperative institution. Some laws protect the cooperative character of farmer associations.¹⁰ But we certainly do not regard laws as setting the absolutely final and unyielding principles of cooperation, any more than laws invented the cooperative.

Charles E. Nieman has provided a broad and well-documented review of judicial opinions as to whether or not an organization is a cooperative. Such opinions do much to clarify legal statutes. In his conclusion, Mr. Nieman states

⁹ Jensen, A. Ladru. *Cooperative Corporation Law on the Marketing Transaction*. 22 Washington Law Review, p. 1. February 1947.

¹⁰ *Farmer Cooperatives in the United States*. Bul. 1, p. 9, Farmer Cooperative Service, U.S. Dept. of Agr., December 1955.

that the essential distinction between cooperatives and business corporations for profit, and between genuine and imitation cooperatives, "is found in the matter of voting control and distribution of earnings."¹¹

In recent correspondence with the authors, Mr. Nieman observed that these features are the two essential manifestations of a single distinction, which is the *purpose* for which a corporation engages in business. Business corporations for profit and imitation cooperatives engage in business for the purpose of deriving income *from* their customers; but the genuine cooperative's purpose is to produce income *for* its customers (patrons).

Although Federal statutes do not provide for the incorporation of cooperatives, they do influence such associations' structural form and methods of operation. The Capper-Volstead Act of 1922, Federal income tax statutes, the Agricultural Marketing Act of 1929, and the Agricultural Marketing Agreement Act of 1937 all contain provisions defining cooperatives for their particular purposes.

Capper-Volstead Act

The Capper-Volstead Act identifies the general functions and specific operational requirements of the cooperatives entitled to the protection it affords.

The act provides, in part, as follows:

That persons engaged in the production of agricultural products as farmers, planters, ranchmen, dairymen, nut or fruit growers may act together in as-

sociations, corporate or otherwise, with or without capital stock, in collectively processing, preparing for market, handling, and marketing in interstate and foreign commerce, such products of persons so engaged.¹²

Attention is especially directed to these points: (1) It is agricultural producers who are authorized to act together; (2) functions specifically covered are marketing and related services; (3) the associations can be incorporated or otherwise, with or without capital stock; and (4) the associations are to market products of persons engaged in agricultural production.

The Capper-Volstead Act also provides that associations covered must be operated for the mutual benefit of member-producers and conform to one or both of the following requirements: First, "That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein"; or second, "That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum." And in any case this requirement: "That the association shall not deal in the products of nonmembers to an amount greater in value than such as are handled by it for members."¹³

Internal Revenue Code

The Internal Revenue Code contains special provisions on the tax treatment of certain farmers' associations.¹⁴ Qualified cooperatives that apply are entitled to these two deductions which other cooperatives and business corporations do not get—amounts paid as limited divi-

¹¹ Nieman, Charles E. *Imitation Cooperatives*. "American Cooperation," 1942 to 1945, pp. 86-100. American Institute of Cooperation, 1945.

¹² 7 U.S.C. 291 and 292.

¹³ 7 U.S.C. 291 and 292.

¹⁴ 26 U.S.C. 521-522.

dends on capital stock, and non-patronage income allocated to patrons. Many farmer cooperatives do not qualify or do not choose to apply under these provisions.

These Internal Revenue Code provisions differ in several respects from those of the Capper-Volstead Act in their identification of cooperatives covered. The Capper-Volstead Act applies only to marketing cooperatives. Cooperatives marketing agricultural products and also those purchasing farm supplies are covered by the special provisions of the Internal Revenue Code if they meet other requirements of the act.

The revenue code contains no requirement relative to the method of voting in the cooperative. It does specify that substantially all of the persons entitled to vote must be producers. Business with nonmembers, up to 50 percent, is permitted, but all patrons, members and nonmembers, must be treated alike. In a purchasing association, not over 15 percent of the business may be done with nonmember, nonproducer patrons.¹⁵

Agricultural Marketing Act

The Agricultural Marketing Act of 1929¹⁶ continues to have major significance for cooperatives because the Farm Credit Act, providing for the Banks for Cooperatives,¹⁷ refers to it for definition of cooperatives eligible for services of these banks.

To be eligible to borrow from the Banks for Cooperatives, a coopera-

tive must be "... an association in which farmers act together in—

"1. Processing, preparing for market, handling, or marketing farm products; or

"2. Purchasing, testing, grading, processing, distributing, or furnishing farm supplies; or

"3. Furnishing farm business services.

"Associations performing a combination of two or more of these services are also eligible."¹⁸

In most other respects the requirements specified by the Farm Credit Administration for borrowers from the Banks for Cooperatives are the same as the requirements of the Capper-Volstead Act. A few provisions are set forth in more specific language derived from the definition in the Agricultural Marketing Act.

At least 90 percent of the voting rights of a cooperative must be held by either farmer-members or by associations owned and controlled by farmers. When not *all voting* rights of a cooperative borrowing from a bank for cooperatives are held by either producers or by other farmers' cooperatives, the banks, as a matter of policy, encourage the cooperative to adopt measures designed to assure that substantially all voting rights will be so held.

Agricultural Marketing Agreement Act

Three sections of the Agricultural Marketing Agreement Act of 1937 require identification of cooperatives in relation to various functions authorized therein. The act itself

¹⁵ Hulbert, L. S., and Mischler, R.J. *Legal Phases of Farmer Cooperatives*. Bul. 10, pp. 196-197. Farmer Cooperative Service, U.S. Dept. of Agr., January 1958.

¹⁶ 12 U.S.C. 1141j(a).

¹⁷ 12 U.S.C. 1134, 1134(f).

¹⁸ *Loans to Farmer Cooperatives*. Circular 6, Rev. 1956. Farm Credit Admin., Washington 25, D.C.

contains only limited provisions specifically defining the cooperatives so affected.

One section, dealing with the right of cooperatives to vote in behalf of their member-producers, says in part—

the Secretary shall consider the approval or disapproval by any cooperative association of producers, bona fide engaged in marketing the commodity or product thereof covered by such order, or in rendering services for or advancing the interests of the producers of such commodity as the approval or disapproval of the producers who are members of, stockholders in, or under contract with, such cooperative association of producers.¹⁹

Provisions for the arbitration of disputes concerning milk contain the following identifying language:

. . . any cooperative association, incorporated or otherwise, which is in good faith owned or controlled by producers, or organizations thereof, of milk or its products, and which is bona fide engaged in collective processing or preparing for market or handling or marketing—milk or its products. . . .²⁰

Other sections of the act extend the rights to pool returns, and to perform other specified services for "the producers thereof" to "a cooperative marketing association qualified under the provisions of the act of Congress of February 18, 1922, as amended, known as the 'Capper-Volstead Act,' engaged in making collective sales or marketing of milk or its products, for the producers thereof . . ." ²¹ The Capper-Volstead Act provisions thus become the basic criteria for recognition of cooperatives for these purposes.

On the basis of these provisions of the act, responsible officials have

developed a set of cooperative qualifications for general use in administering the Federal milk marketing orders. The significance of these qualifications to dairy cooperatives is discussed later in this report.

Summary of Legal Provisions

The Federal statutes cited above thus identify organizations as agricultural cooperatives on the basis of: (1) The functions to be performed, (2) who the members are, (3) for whom services are performed, (4) the amount of business with non-member-patrons, (5) who votes and how they vote, (6) mutuality of treatment of member-patrons, and (7) the extent to which stock or membership capital, as such, participates in the earnings.

These identifying features which have been incorporated into the laws are prescribed practices, based largely on experience, designed to



A co-op employee talks with a farmer-member. To qualify as a farmer cooperative, the association must see that its members are farmers and its services are for farmers.

¹⁹ 7 U.S.C. 608c(12).

²⁰ 7 U.S.C. 671, Sec. 3(a).

²¹ 7 U.S.C. 608c(5) F.

carry out and protect principles which are considered basic.

Basic Principles

In the foregoing sections, we have noted that an agricultural cooperative is an organization composed of producers. Its purpose is to perform one or more functions or services for its member-patrons.

Our consideration of objectives and the preceding summary statements on the nature of cooperatives have emphasized and essentially have been confined to their business character. Consideration of basic principles, however, and the criteria developed later in this report, include relationships among people.

All business organizations and actions are the actions of people. They necessarily apply their own value judgments and personal objectives in their business relationships, although ordinarily this is not realized at the time of individual decisions. This study and report, however, require us to pay specific attention to personal objectives and relationships.

In many respects, there is little or no difference between business operations or services conducted by cooperatives and by other types of organizations. A cooperative dairy plant, for example, may be built from the same plans as a proprietary plant. The plants may use identical equipment and sell their products in the same markets. The casual observer sees very little difference between the two in the way they conduct their business.

In spite of these external similarities, objectives, basic principles, and internal lines of authority in policymaking distinguish cooperatives from other forms of business organization. The cooperative is

acknowledged to be a form of organization particularly adapted to serving the needs of agricultural producers. However, the cooperative form of organization may be employed by any other group of people or corporations who want this means of getting services rendered at cost.

Neither students, writers, nor practical cooperators are in full agreement as to all fundamental features of the cooperative as a form of organization. There is general agreement, however, with respect to three basic principles, or supporting pillars, around which cooperative organizations are constructed and which distinguish them from other types of business organizations in our free enterprise economy.

These three underlying or "hard-core" principles are:

1. Service to members at cost.
2. Democratic control by members.
3. Limited returns on capital.

There are substantial differences between cooperatives and other types of business in each of these respects.

Some present-day observers maintain that service to members at cost is the only truly basic principle—and that the other characteristics, democratic control and limited returns on capital, only serve to support and insure this first principle.

"Cost," as used here, includes a limited return on capital, whether paid directly or included in other returns. Equity capital in the cooperative receives only a limited return or frequently no direct return at all. Other earnings or margins are returned or allocated to patrons in proportion to their patronage. In other types of businesses, earnings are paid the owners in propor-

tion to the common or preferred stock each owns. The cooperative serves its patrons at cost—other types of business serve their customers for a profit.

The cooperative is controlled democratically by its members. A policy of one vote per member or of voting in proportion to patronage is usually followed. Other types of corporations generally are controlled in proportion to equity capital invested.

Democratic control and limited returns on capital may be considered essential protective bulwarks to keep the organization oriented to service of its patron-owners. It may also be reasoned that the principle of service at cost automatically includes the principle of limited returns on capital, and therefore the third principle overlaps the first. Whether these principles are counted as one, two, or three, the significant point is the agreement that the ideas stated are appropriate and important. Interrelationships add rather than detract from their strength as a group.

Writers have referred to many other characteristics of cooperative organizations as basic principles or as fundamentals of cooperation. These characteristics, which may be considered secondary principles, can be classified in three categories:

1. Principles of good business organization, finance, and management which are essential for cooperative success but which apply

equally to other types of business. Examples: Sound accounting practices; budgetary controls.

2. Practices and policies designed to implement the three basic principles. Examples: Voting practices (most frequently one-man one-vote); pooling; allocation of net margins; revolving fund financing.

3. Practices and policies which are or have been followed by cooperatives generally in the past but which are not limited to cooperatives. Examples: Fair dealing; credit control, and sometimes credit prohibition ("cash trading"); functional and commodity specialization.

The three "hard-core" principles provide the basic rules of cooperative action. They are, in a relative sense at least, fixed characteristics of a bona fide cooperative. The exact form of organization, the policies and practices, and the methods cooperatives use in conducting business to comply with the basic rules are much more flexible. It is through changes in these secondary characteristics, as opposed to changes in basic principles, that cooperatives usually adjust to our dynamic economy.

We do not intend to imply, however, that adherence to the three basic principles should be *the* objective of a cooperative. These principles are a means to an end, not an end in themselves. The end is the financial benefit of the patrons.

Determining Cooperative Character of Dairy Organizations

WE now turn to a consideration of how to check the qualifica-

tions of an organization seeking to be accepted and recognized as a co-

operative, and how to appraise its ability to maintain its status as a cooperative in the years ahead.

A dairy marketing organization should be required to meet certain standards before it is accepted as a cooperative. Farmers, other organizations, and public agencies concerned with cooperatives all need to have such standards available for their use. Industry leaders also have been concerned with the problem of distinguishing between a real (*bona fide*) and an imitation (*pseudo*) cooperative.

This section provides criteria for identifying the qualifications of a recognizable cooperative, and discusses the interpretation and application of those criteria.

Most discussions of genuine versus imitation dairy cooperatives have involved alleged captive organizations. The captive idea usually means the organization is thought to be controlled by a particular milk handler, rather than by the farmers themselves. But other captive alignments are possible, with ties to creditors, milk haulers, labor unions, or even other organizations of farmers. The standards should detect improper control or influence from any source, and not from milk handlers alone.

The standards also must extend beyond minimum forms of organization in order to indentify a cooperative that is providing actual service to its member-patrons. Surely farmers should reject an organization that, even though it is founded on cooperative principles, is not performing needed marketing services.

State and Federal officials also may refuse to grant rights reserved for cooperatives to organizations that do not qualify for those rights under the terms and for the pur-

poses of programs being administered. Thus, our standards for dairy cooperatives must give specific guidance; a simple minimum set of cooperative principles is not adequate.

We indicated in outlining basic principles of agricultural cooperation that these included and perhaps emphasized relationships among people. Such relationships often are not clear cut and perfectly objective. This feature greatly complicates the task of establishing standards or criteria for identifying agricultural cooperatives.

Most standards we will set forth apply not only to dairy cooperatives but also to other specialized or diversified cooperatives. Therefore, the word "dairy" may appear infrequently in the following discussion. It is included only where conditions appeared to require special provisions for dairy cooperatives, or there was a possibility that a statement might apply differently to other commodity areas.

Positive answers to three general questions will go a long way in assuring that a dairy marketing organization is operated as a *bona fide* farmer cooperative and can maintain such operations. These questions are:

1. Is the cooperative performing *marketing services for members* in their best interests?

2. Is the cooperative organized so that *producer-patrons control* it now and can be sure they will control it in the future?

3. Is the business of the cooperative conducted in accordance with *sound business practices* which will assure its continuing ability to provide services to producer-patrons at cost?

The means of obtaining true answers to these questions are not

simple nor will they be the same under all circumstances. Exact criteria which can be applied generally to test the answers to these questions cannot be devised. However, we can list and discuss important points for the cooperative member to consider in answering the questions about his own dairy marketing cooperative.

One point can be cleared up immediately. Members may either be individuals or other farmer cooperative corporations.

Marketing Service for Members

The first basic principle of agricultural cooperation cited earlier was service to members at cost. Two major requirements to demonstrate this service will be discussed here.

First, marketing services must be performed by the cooperative. In some cases cooperatives accomplish this by acting as agent for their members in obtaining tangible performance by third parties. Second, marketing must be primarily for members. Both these requirements at first appear simple, even obvious. But they may be troublesome underneath this deceptively simple first appearance.

Performance of Marketing Service

The definition of marketing in dictionaries, encyclopedias, and standard textbooks is very broad. Numerous functions may be regarded as marketing. These include buying, selling, storing, transporting, processing, standardizing or otherwise preparing for market, risk bearing, supplying market information, and other services to buyer or seller.

Most cooperatives definitely engage in marketing by doing one of three things (and often the first or

second plus the third listed):

1. Purchasing and selling products with title passing to and from the cooperative.

2. Acting as agent for the seller in negotiating price and other terms in the sale of products, often under the authority of a written contract.

3. Physically receiving and handling products.

Although most cooperatives perform far more than these minimum functions, any one of the three is adequate to demonstrate marketing.

Some organizations do not meet marketing service requirements because their sole purpose is to represent their members (farmers, laborers, handlers, or others) for legislative purposes, or for general advancement of an industry. These activities do not involve services in the sale of specific and identifiable articles in commerce and the organizations are not engaged in marketing.

Physical Handling.—Cooperatives that do not physically handle products may have a problem in establishing their marketing status.

In these days of bulk handling, there is not necessarily any marketing advantage for a cooperative in physically receiving milk over hauling it in its own trucks or in contract trucks. In 1957, about 700 dairy cooperatives marketed some whole milk without any processing. (This was only part of the marketing operations of many of the 700, however.) Much of this milk was not even physically received and re-shipped.

Thus, physical receipt of milk has become less generally useful as a criterion of marketing authority. On the other hand, physical handling alone may not always be an adequate test of marketing. For example, cooperatives applying for



Physically receiving and handling products is one evidence that a cooperative is performing marketing services.

recognition under Federal milk orders are asked if they have "full authority in the sale of milk."

Most, if not all, associations that meet other cooperative criteria and that physically receive milk are performing marketing services. But it seems essential to limit attention to the *exchange* function of purchasing and selling, in identifying a marketing cooperative for the Federal order program.

Marketing Agreements.—Since many cooperatives market effectively without physically handling the product, other criteria of marketing performance are needed. A long-term and desirable trend is toward marketing agreements for all cooperative dairy marketing operations. Contractual marketing agreements may appropriately be made an essential criterion for recognition as a cooperative under some State and Federal marketing programs.

A cooperative's marketing agreement with its patrons may take several forms. For member-patrons, the agreement may be set forth in a bylaw. For nonmember-

patrons, it may be such a bylaw, plus the patron's signed receipt for his copy. For either group, it may be a separate, written agreement signed by the patron. This latter form is the best known.

In some cases, properly witnessed oral agreements must be accepted. This situation arises when the agreement involves persons whose religious beliefs do not sanction written agreements.

Regardless of its form, the agreement should plainly obligate the patron to deliver to or for the account of the cooperative all milk (or any other commodity the agreement is intended to cover) produced on his farm in excess of his needs for home use. It should plainly authorize the cooperative to market the commodity either for the patron's account or the cooperative's account.

The agreement is of little value unless it states the period of time covered and provisions for termination.

Dairy Cooperative Association

Membership and Marketing Agreement

1. _____
2. _____
3. _____
4. _____
5. _____
6. _____

[Signature] _____
[Signature] _____

A contractual marketing agreement provides specific evidence that a cooperative is engaged in marketing.

Quality and Extent of Marketing Service.—Once it is established that the organization performs marketing, member-patrons, at least, will want to evaluate the quality and extent of that service. In carrying out its responsibilities, an administrative agency may also need to determine that certain services are being performed and that they meet specific standards.

The Federal milk marketing order program provides an illustration. Standards may be adopted governing butterfat testing, check weighing, marketing information, or other services. These problems will be discussed in more detail in the section "Cooperatives and Federal Orders."

No set rule can be laid down as to what functions a particular dairy cooperative should undertake. Some guides may be established, however. Those that follow are prepared for the use of members, directors, and leaders; they are not for administrative agencies.

Answers should be sought to two questions: (1) What services do the member-producers need? and (2) Can the association perform the needed services as well or better than other marketing agencies?

If the answer to the second question is negative, and it will be in numerous cases, it would probably be advisable for the cooperative to merge, federate, or otherwise associate itself with another organization which is in better position to serve the producers' interests. In some cases, liquidation will be the only answer.

These are the principal alternatives for leaders who, in the process of evaluating and making plans for an existing association, conclude that major organizational changes

are required. An individual producer can simply decide another cooperative or noncooperative buyer can better serve his needs.

The means of bringing about affiliations of cooperatives or other marketing organizations is beyond the scope of this report. The same is true for methods of establishing needed additional marketing services, discontinuing unneeded ones, or improving the quality of services. But evaluation of the kinds and quality of services performed is highly important. If a cooperative cannot keep pace with rapidly changing conditions, it should reorganize or be discontinued. The same is true of other marketers.

Marketing for Member-Patrons

As noted earlier, the Capper-Volstead Act requires that at least 50 percent of marketing business must be with the products of members. We accept 50 percent as a minimum standard. Cooperatives thus demonstrate that they are at least principally marketing for producer-members and not for others.

Limited Marketing for Nonmember, Nonproducer Patrons.—Marketing for other than producers and other farmer cooperatives should be severely limited. This limitation is necessary because the most obvious motivation for such "external" operations is to obtain profits as owners, not improved returns as patrons. The primary distinctive purpose of the cooperative—obtaining service for member-patrons at cost—is diluted and weakened by all "external" operations not integrally related to marketing needs of members.

We propose as a criterion that not more than 10 percent of the raw product value of products marketed should be for other than individual

producer-patrons and other farmer cooperatives. Exceptions may be made to this criterion in certain individual instances.²²

An exception may be made if it is shown that effective marketing of members' products requires marketing other products that are related in merchandising by trade custom. The need in modern merchandising to sell a broad product line must be recognized and accepted. Thus, if most dairy distributors in a particular region handle flavored drinks and orange juice, dairy cooperatives must also do so to stay in business.

Some dairy cooperatives operate a dairy bar, or even a lunchroom, for such purposes as local retail sales, sales promotion through getting the public to visit the plant, and lunch service to employees. In such an operation, the items sold cannot successfully be limited to those made from members' milk. Dairy bar and lunchroom service may thus be considered as integrally related to marketing of members' products, although nondairy products are sold.

Other Activities.—Sometimes in purchasing a milk packaging and distributing business or in otherwise expanding its market outlets, a cooperative acquires a nonfood operation or one not directly connected with its present activities. A cooperative might, for example, acquire a bakery, candy manufactur-

ing plant, or soft drink bottling plant.

There would be a substantial problem in providing that these activities were needed to market the products of member-producers, and that such need overrode the interest in profits as owners. Continuation of such lines would steadily raise the question of whether the organization was a bona fide farmer marketing cooperative.

Cooperatives that have idle facilities and equipment face a difficult problem if they wish to retain those facilities for possible use in the future. Processing food products not supplied by members, or carrying on nonfood operations may be the best way to gain a return on the cost of holding and maintaining the facilities. It is unreasonable to quickly condemn such operations by a dairy cooperative if it is reasonably possible that the facilities will be needed in the future for products of member-patrons.

The backhaul problem for trucking operations is another illustration relating to idle equipment. Backhauls are important in maintaining efficient trucking operations. The "service for members" principle of cooperation is safeguarded if such backhauls are related as closely as possible to the needs of member-producers, with needs of other agricultural producers taking second priority. But we believe backhaul service is a justified exception to the practice of service only for members, if this is the only realistic alternative in maintaining efficient hauling operations.

Both member-leaders and public administrative officials should periodically review the need for any remotely related marketing enterprise. If the need no longer exists,

²² Internal Revenue Service requires that any marketing for nonproducer patrons, other than farmer cooperatives and the U.S. Government, by so-called tax "exempt" cooperatives be justified by a showing that such marketing was not substantial and was required by special circumstances such as being needed to meet contract commitments.

the cooperative may take two types of action. The most clear cut is to sell or lease the facilities not used in marketing for members. If this is not prudent, the cooperative may consider setting up a subsidiary corporation to conduct the operations in question.

At least a few dairy cooperatives already maintain subsidiaries for such purposes. The subsidiary corporation should help keep the cooperative's attention centered on dairy marketing or other operations that directly serve its members as patrons. Setting up a subsidiary also helps segregate taxable from nontaxable revenues for corporate income tax purposes.

Our distinction between dairy and nondairy operations is not intended to condemn diversified marketing or marketing-purchasing cooperatives. Diversification by combining dairy with other marketing activities may increase in the future. This, however, raises no doubts as to whether the organization serves the marketing needs of the members.

But the dairy cooperative should bear the burden of proof that it is principally engaged in marketing for members. This is appropriate since most definitions and descriptions of farmer cooperatives emphasize self-service. This idea imposes a definite limitation on cooperatives. All operations should be tested to determine whether they are essential to members as producers in marketing their farm products or purchasing their needed farm supplies.

The special situations described are intended to help farmer-leaders and public administrators give a practical interpretation to the idea of essential marketing services.

Control by Member-Patrons

Member-patron control is vitally related to the service-at-cost principle. It is a major safeguard because it enables members to refuse or reverse any action or policy of the cooperative that is contrary to this principle.

The question of control is especially critical in a changing, dynamic economy. Today, changes must be made frequently for an association to survive, much less to serve. Control must rest at the same point that the objectives and benefits are focused—with the producer-patrons—to insure that those objectives are preserved even though changes are made.

The first checkpoint for control by member-patrons is whether the organization is incorporated under the cooperative or equivalent State statutes. The second is whether the cooperative is actually functioning consistently with the statutes.

Provisions of these enabling acts vary by States and cannot be tabulated here. However, the laws emphasize two features. The first is provision for democratic control by stating how members shall vote. The second is a limit on returns on capital.

Incorporation under a cooperative law does not alone assure control by member-patrons. It is necessary to examine the connecting links between members and other parts of the cooperative body to determine the real character of the control.

There may be major advantages in a few cases in incorporation under general corporation acts, rather than specifically under cooperative acts or sections. A corporation may be able to fully follow cooperative principles and practices

under such statutes and articles of incorporation. However, internal or external appraisers of such a corporation should use great care in reviewing its compliance with cooperative principles and practices before accepting it as being truly cooperative. While the corporation need not automatically be rejected as a cooperative, it certainly assumes an increased burden of proof.

In membership appraisal, we should direct our attention to: (1) Who are voting members, (2) who actually controls the organization, and (3) what are the policies to retain membership and control in hands of members who are producers as well as patrons?

Who Qualify as Members

The Capper-Volstead Act and other Federal statutes based on it specify that, for the purposes of these statutes, voting members of an agricultural cooperative should be producers of agricultural products. Most students go further, however, and agree that members of any individual cooperative should not only be agricultural producers but also should have a high degree of common interest in using the services offered by the cooperative.

The Internal Revenue Code applies this principle in requiring that substantially all the voting members of a so-called "exempt" cooperative must also currently patronize it.

Three tests for assuring the common interest of members will be discussed: Producer status, patronage, and membership acceptance of responsibility. Many cooperatives also follow a policy of open membership. We will discuss this policy but we do not recognize it as being suitable for all cooperatives.

Producer Status and Patronage.—

The membership of a dairy cooperative should be composed of producers who patronize it by marketing their milk and dairy products or by using other of its marketing or purchasing services.

Some producers may believe that an organization should be limited to dairy marketing in order to represent them acceptably as a dairy marketing agency, or at least that only dairy patrons should be permitted voting rights. Others may feel a cooperative with diversified activities can serve them better.

Our judgment is that the degree of specialization or diversification of a cooperative should be left to its producer-members. Many farmer cooperatives engaged in marketing will have numerous members who are not dairymen but who patronize other departments.

To minimize the temptation and tendency to adopt policies leading to services for a profit, rather than services at cost, voting rights must be limited to persons meeting the producer and patronage requirements.

Producer-patron members can be entirely satisfied with the objective of improved returns from marketing on a service-at-cost basis. Non-producer-members may be principally interested as investors, and may logically focus attention on returns on capital.

Confining voting rights to producer-patrons also helps prevent the cooperative from becoming a social or political rather than an economic institution. Any group of farmers may initially sponsor a cooperative, but voting rights should be extended only to patrons. When a cooperative is first organized, this may be interpreted in terms of an expressed

or implied commitment to patronize.

Even when patronage is a requirement for voting, membership may shift into the hands of non-producers. Should this happen, members may consider several methods of handling the situation. They may allow the shift to continue, with the possibility that their association may someday lose its identity as specifically a cooperative of agricultural producers. They may properly limit membership to a certain group by refusing the patronage of other groups, such as nonproducers.

As still another alternative, they may decide to discontinue the services that are bringing in the unwanted class of members, possibly by assisting in organizing a second cooperative for other distinct types of operations.

Members may consider similar alternatives if they are concerned about nondairymen gaining voting rights. Acceptance of the situation, refusal of patronage, discontinuance of services, or organization of a new cooperative offer possible solutions.

If State laws permit, a change from the one-man one-vote practice to proportional voting may be helpful. This may be particularly suitable if the cooperative markets more than one product, or has both marketing and purchasing operations. One department or operation, such as dairy marketing, may account for most of the dollar volume of business, but the number of nondairy patrons may greatly exceed the number of dairy patrons. In this situation, proportional voting would retain control for dairy producers. Each of these alternatives preserves the cooperative prin-

ciple of mutuality in control, patronage, and benefits.

The requirements and policies of the Farm Credit Administration for lending by the Banks for Cooperatives can be used as specific standards for reviewing the membership of an organization desiring recognition as a farmer cooperative engaged in dairy marketing.

Following the policies of Farm Credit Administration, we suggest as a standard that at least 90 percent of the voting rights should be held by either farmer-members or by associations owned and controlled by farmers. When more than 10 percent of the voting rights in a farmer cooperative are held by others, the cooperative should show it has adopted measures to assure that this percentage will be reduced.

If membership is limited to patrons, when shall voting rights of members who become inactive as patrons be discontinued? This is a relatively simple problem for dairy patrons. Voting rights should be discontinued immediately for members who cease to patronize because they close their dairy enterprise by selling or leasing their herd or farm (unless on a share basis), or who retire or die.

Voting rights should also be discontinued immediately for members who continue producing milk, but begin to sell their milk to another firm or through another cooperative. An exception may arise if the member continues his membership eligibility by marketing other products through the cooperative or patronizing farm supply or other service departments. Voting rights of members who experience a disease outbreak, fire, or other calamity may be continued for up to 1 year.

It is more difficult to provide a

specific policy for ending voting rights because of failure to patronize nondairy marketing departments or farm supply or other services. Farmers' needs in those departments are more likely to vary or to be seasonal. But voting rights should ordinarily be ended for persons who have failed to patronize any of the departments of the cooperative for 12 months. An exception may be made in the case of a total crop failure or other calamity.

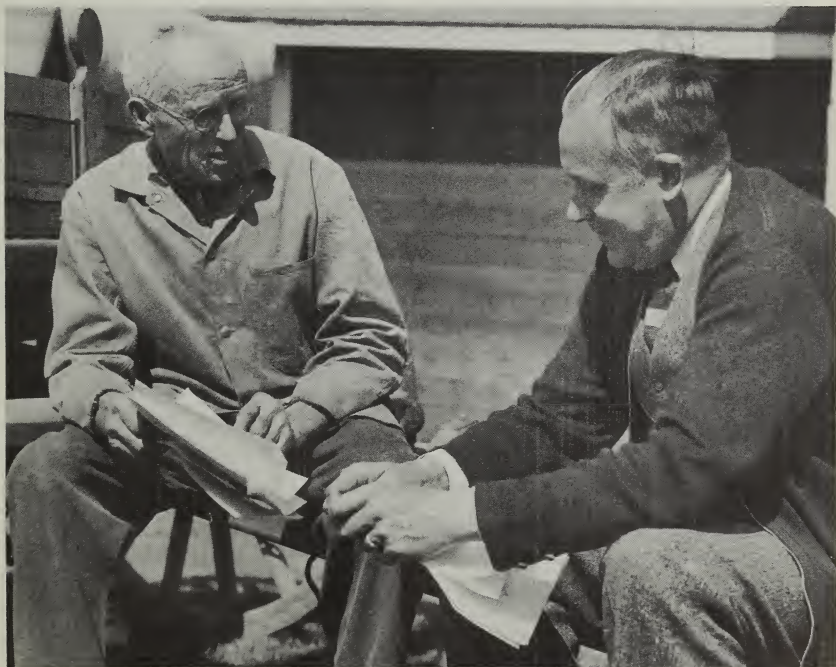
Membership Responsibilities.—A method of determining the interest of producers before membership rights are extended would do much to reduce the "deadwood" on member rolls of dairy cooperatives. Making patronage a prerequisite to acquiring or maintaining voting rights and promptly clearing the membership rolls of nonpatrons

help to insure that persons interested in the services the cooperative provides will form its policies. But something else is needed.

Requiring a marketing agreement helps to insure that applicants for membership accept responsibility for patronage. But, from the practical point of view of the probability of general acceptance, we think it is too soon to insist that all dairy marketing cooperatives require marketing agreements.

Our further proposals are suitable for internal self-appraisal by cooperatives, but probably are not sufficiently clear cut and objective to apply externally in governmental or other programs.

Membership is very easily acquired in most dairy cooperatives. In some cases a producer who makes a delivery of milk or farm-sepa-



Cooperatives could gain stronger membership ties by person-to-person counseling with potential members. New members would thus know more about their responsibilities.

rated cream to the cooperative becomes a member by the simple expedient of authorizing the deduction of a small membership fee or part payment on a share of stock from his first check.

The producer-patron may thus become a member without adequate knowledge of the duties and responsibilities he is assuming. He may be unaware of any benefits he may reasonably expect from the cooperative, other than the service it has already provided by accepting his product.

Cooperatives could strengthen ties with their members by counseling with them in advance to determine their interest and qualifications as cooperators. By "qualifications as cooperators," we mean at least basic understanding of how the cooperative is organized; the responsibilities of membership; and the importance of participation in the affairs of the association.

The following statement of Henry Bakken should help to clarify the meaning of the term, "qualifications as cooperators." He said:

The most ideal condition under which a cooperative may be operated is that of having an intelligent membership of efficient producers who: (1) Recognize the need for organization; (2) have the patience to work out their problems; and (3) will give the necessary support to the employees and management of the enterprise.²³

He called for the current members of a cooperative to pass on applicants' qualifications.

Open Membership?—It is sometimes reasoned that membership in an agricultural cooperative should

be open to any agricultural producer who wishes to join. However, the need for common interest among producers and the desirability of determining their qualifications as cooperators may be more important than the value of open membership.

From an economic standpoint, a selective rather than open membership policy may sometimes be more to the interest of present member-patrons. Either limited facilities or limited markets may dictate a policy of closed or controlled membership.

We thus conclude that membership in a cooperative need not be open to all who apply.

Do Members Exercise Rights?

The cooperative form of organization endeavors to assure producer-patrons that the affairs of the association will be conducted in their interest. As mentioned earlier, it does this, first, by limiting voting rights and thereby control to members who are both producers and patrons. Bylaw provisions concerning the rights of producer-patron members to control the cooperative are of little consequence, however, unless those members exercise their rights.

When members of a cooperative as a group fail to exercise their rights, others will assume control. This may be a clique of members, a board of directors acting as individuals instead of representatives of members, hired management, or outside interests. Cooperatives are not unique in this respect; similar problems exist in other organizations.

Control by members who are producer-patrons and who will benefit from the organization is basic. In describing the nature of a coopera-

²³ Bakken, Henry H. *Principles and Their Role in the Statutes Relating to Cooperatives*. Wisconsin Law Review, vol. 4, p. 554, July 1954.

tive Edwin G. Nourse once said :

... cooperation is a means of organizing the members of an industry to conduct and adjust its affairs in the common interest of the group and no amount of benevolent despotism or pure efficiency of a remote management will take the place of continuous, active, studious participation by members in the formulation and carrying out of plans and policies.²⁴

The methods by which members control a cooperative require further exploration before we discuss how to determine whether such control really exists. Business efficiency and good business practices require the delegation of authority and responsibility. It is evident that each of several thousand members, or even several dozen, cannot give day-to-day orders to the staff.

When members of a cooperative elect a board of directors, they automatically delegate to it broad authority over the policies of their association. For example, the authority of the board of directors to vote on behalf of members is recognized under the Federal milk marketing order program. The board also hires the manager and through him directs the business operations.

Successful membership control in a cooperative involves close adherence to democratic processes and action as a group. Willingness to accept majority decisions and abide by them until altered by later action of the group is an essential characteristic of a good cooperative member.

Full and complete control by producer-patron members is thus basic to cooperation. Democratic methods, involving majority rule

and delegation of authority, are essential to implement member control and do not detract from it. Measures of member control must be devised that are consistent with the demands of this democratic situation.

How Many Votes?—Most dairy cooperatives give each member one vote, and no more. A system of voting based on the proportional use a member makes of the cooperative's service also is democratic and under some conditions may be more practicable than the one-man one-vote system. The proportional system may be modified by limiting the maximum number of votes.

Extra votes for additional shares sometimes are used as a device reflecting volume of patronage. If this is done, the number of voting shares should be kept in current adjustment to volume of patronage.

Cooperative laws in about three-fourths of the States provide that no member or shareholder shall be entitled to more than one vote regardless of the amount of stock owned, or the extent of his patronage. Because of these provisions, and the tradition interwoven with them, a substantial majority of the members of cooperatives probably regard the common "one-man one-vote" practice as a basic principle of cooperation. However, "democratic control by members" is the basic principle and one-man one-vote only one way to carry out that principle.

Dissatisfaction with the one-man one-vote system is most likely to arise in associations whose membership includes some large producer-patrons and many more smaller producer-patrons who can control on a one-man one-vote basis. In States where the cooperative laws permit, organizations faced with

²⁴ Nourse, E. G. *The Evolving Idea of Cooperation in the United States*. American Cooperation 1928, vol. 1, p. 16. The American Institute of Cooperation.

this conflict of interests may find a system of proportional voting better adapted to their conditions. Cooperatives in other States may want to seek amendments of laws to gain for themselves the opportunity to use proportional voting.

Laws of some States permit issuing more than one voting share of stock to an individual member. Cooperatives following such practice must be recognized in those States. However, this practice, unlike voting in proportion to patronage, endangers the basic principles of control by producer-patrons and of operation at cost. In these cases, therefore, exceptional attention should be given to other indications of control by producer-patrons and of operation at cost.

Member Participation.—A high level of member participation at business meetings goes a long way to demonstrate that members control a cooperative. Thus, in self-evaluation, leaders of a cooperative will find this a good index of member control.

However, we do not recommend that a specific criterion of member participation be applied in State and Federal administrative programs. A great variety of situations would have to be considered, including number of members, size of area served, extent of diversification, and some organizational details.

The first step toward better member participation is to call attention to its importance and set some standards for self-evaluation. Specific standards in terms of higher quorum requirements may be possible later.

In reviewing operations and discussing the cooperative's plans and policies at its business meetings, free discussion is very important.

Members should be encouraged and given a meaningful opportunity to express their views and ask questions.

Qualifications of Directors and Committees.—Members of a cooperative may properly appraise the qualifications of directors and other officials. The following questions are appropriate:

1. Do the same persons serve as directors and on important committees for long periods of time?

2. Is each one so outstandingly qualified that sound judgment requires his continued service?

3. Do all members qualified and willing to serve in such capacities get an opportunity to do so?

Members who answer "yes" to the first question and "no" to the second and third are thereby making a serious criticism of their cooperative.

Are Policies Followed?—Members may also appraise director's and manager's adherence to formulated policies.

1. Does the board of directors adopt policies consistent with decisions made by the membership as a group?

2. Does the general manager direct the business in line with duly established policies?

Conflicts of Interest

Members of dairy cooperatives, as well as directors of State and Federal administrative programs, should search carefully for conflicts of interest. The organization should not be accepted as a cooperative until this review has been completed satisfactorily. Such a search may reveal a captive situation.

This checklist may be helpful:

1. Do directors or managerial employees have interests in other dairy enterprises (or other lines of business) which may conflict with

the interests of the producer-patron members?

a. Do they own stock in other dairies operating in the area?

b. Are they employed by or do they receive any compensation from other dairy firms in the same operating area?

c. Do they receive commissions or gifts of more than nominal value from suppliers or customers of the cooperative?

2. Does management enter into contracts or other business arrangements which place outside interests in the position of dictating policies of the association?

Any contract delegating general management to another firm (rather than employing an individual) should be examined in detail for evidence of conflict of interest. Sales contracts also should be examined for any commitments by the cooperative organization that are not essential to rendering adequate service.

3. Is the organization indebted to its buyers?

Substantial indebtedness usually carries with it considerable management and policy influence. A cooperative organization ordinarily should not borrow money from firms to or through which it sells products.

Exceptional circumstances may justify such borrowing. But, it raises a question about cooperative status and places a heavy burden of proof on the cooperative to show that its policies are not influenced as a result.

4. Does the organization or do any of its officers receive any funds or financial support from milk handlers or buyers of other products marketed, except from the sale of products and from moneys duly authorized by members to be de-

ducted from their marketing returns?

5. Do any persons employed by milk handlers or buyers of other products marketed attend board meetings or assist in formulating policies of the organization?

6. Have any officers or employees of milk handlers, buyers of other products marketed, or independent haulers solicited members for the organization?

7. Was there any evidence of conflict of interest in the circumstances under which the association was organized, especially in relation to—

a. Who started the organization and what was the immediate purpose in setting it up?

b. Were any milk handlers or buyers of other products marketed instrumental in its organization or did they use any influence in connection with it?

c. Did the lawyer who aided in the incorporation or in drafting legal papers of the organization then act as counsel for any firms that bought milk or other products from the organization or has he since done so?

8. Have any lawyers retained by the cooperative during the last 2 years acted as counsel during that same period for any firms to which milk or other products are sold?

Farmer cooperatives have a special interest in insuring control by producer-patron members, but the concern about conflicts of interest is shared by other business concerns. Searching for such conflicts is simply a matter of prudent management.

Will Cooperative Character Be Maintained?

We will now assume that the organization papers of the dairy cooperative are in order and provide

adequate recognition of cooperative principles. The membership is composed of producers who patronize the cooperative, and members control the association through democratic processes. The foundation thus appears to be sound. Before passing final judgment, however, we should consider whether provisions have been made to protect it from decay.

The following guides to future cooperative character are for members and leaders to use in this appraisal. State and Federal officials probably are more concerned with present conditions than with what may arise in the future.

Since both farming and marketing conditions change rapidly, past policies may not be successful in the future. Thus, an association's past and present performances do not fully insure its future ability to serve.

As a cooperative grows, membership and management practices, which served well when its business was primarily local and the individual members knew all the directors and the manager personally, may no longer be adequate. We must assume that as the cooperative becomes larger patrons will begin to lose contact with the management unless definite measures are taken to prevent such a development. What indices may be used to know whether such measures are being taken?

Is Membership Static?—Keeping the membership of a cooperative in the hands of active patrons is not a particularly difficult task. It will not occur automatically, however. Members, directors, and managerial employees must all be aware of the desirability of such a policy and must support it by their day-to-day actions.

Dairy producers are not a static group. They die, move out of the area served, or discontinue dairy production. Meanwhile, boys grow up and take over the dairy herds and new dairymen move into the area. Without the patronage of these new producers, a dairy cooperative's business will wither away. Without their membership, it will become an organization of nonresident or retired persons.

Accordingly, we should seek answers to these questions:

1. Does the association operate in a manner to attract the patronage of new producers?

2. Do members "sell" their association to prospective patrons?

3. Is there a definite policy of encouraging qualified nonmember patrons to become members?

4. Does the association systematically remove nonpatron members from the membership rolls?

Good Communications Are Essential.—Cooperative members can exercise effective control only if they are informed regarding the organization and the business it conducts. A regular and continuous two-way flow of information and ideas is essential to well-coordinated actions of members, board of directors, and managerial employees.

The larger the cooperative, the more important planned communication becomes. Day-to-day contacts between members and the managerial staff grow less frequent as the size of the organization increases. Their adequacy as a means of communication thus decreases and more formal means must be relied upon.

We emphasize the specific need for information that enables member-patrons to evaluate performance of the cooperative. The first question may be, do patrons under-



Membership in a cooperative cannot remain static. Newcomers to area should be visited and told about advantages of co-op.

stand and correctly interpret their returns from marketing through the cooperative? If patrons merely compare the net pool price of the cooperative with competitive prices, many deserving dairy cooperatives may find themselves at a disadvantage.

Therefore, patrons should be well informed about cooperative benefits so they can base their support on more than comparison of current prices. They should be in a position to—

1. Compare quantity and quality of services performed.
2. Consider end-of-the-year patronage refunds.
3. Consider their accumulated equities in the cooperative.
4. Consider the long run effect of the cooperative on the competitive price level.
5. Consider the value of having an organization whose future

functions they can control.

A recent study in Wisconsin indicated that some dairy cooperatives were at a competitive disadvantage because of lack of price information and failure of producers to understand that which was available.²⁵ Producers often lacked information on basic prices and grade differentials of the numerous competing buyers. Benefits, other than price, were not fully understood.

In their report of this study, the authors suggested improved educational programs, less emphasis on end-of-the-year patronage refunds, and more emphasis on cooperative pool prices as a means of dairy cooperatives increasing their effective competitive strength.

²⁵ Burnett, Claron, and Clodius, Robert L. *Procurement Policies and Practices of a Selected Group of Dairy Processing Firms*. Research Bul. 211, Univ. of Wis., Madison, May 1959.

Dairy cooperatives operating in today's markets cannot afford to ignore price competition. However, a cooperative will be better able to adapt its operations to changing conditions without loss of its cooperative character if the membership is reasonably well aware of *all* the advantages offered. But even well-informed members cannot be expected to continue supporting an inefficient cooperative.

Providing the business information and knowledge needed for intelligent action on cooperative affairs is a good beginning for a communications program aimed at maintaining and improving control by producer-patron members. A further step is needed, however. Unless the communications also inspire in producer-patron members a desire to create or maintain control, the business information provided will do little good.

Factual accounts of accomplishments of dairy and other cooperatives with emphasis on the part cooperative members played are useful. In telling the "Cooperative Story" we should be careful to present both sides, however. Problems as well as accomplishments should be discussed. Necessary participa-

tion in control and in financing should be given equal billing with benefits to be derived. The story should be told so member-patrons or prospective member-patrons will see that there is no magic in cooperative methods—that benefits are dependent on participation.

A good communication system will fill many needs. We emphasize that control by producer-patron members is much more likely to be maintained when communications:

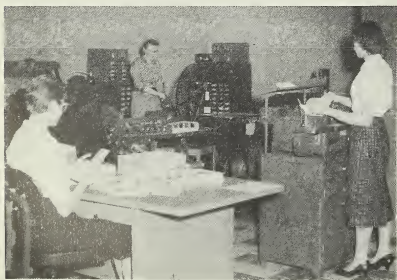
- (1) Provide for two-way flow of information and ideas;
- (2) present technical and economic information in understandable form about the cooperative, its business, and its problems; and
- (3) create a desire among the members to participate.

Sound Business Practices

A loyal membership that believes in the principles and objectives of cooperation is a valuable asset to any cooperative. Objective observation of cooperation in action indicates, however, that such belief and loyalty are mainly derived from successful operations. Loyalty in turn contributes to continuing success when members are properly informed about the accomplishments of their cooperative.

Successful operations and loyalty are thus interrelated—each influences the other. But the first requirement is demonstrated economic benefits: Business success derived from sound business practice.

Only a few of the criteria of business methods that are discussed here can be applied objectively. These may be included in administrative criteria of cooperatives. The other points and questions may be employed in self-evaluation by cooperative members and leaders.



A good communications program is a valuable asset to any cooperative. Miami Valley Milk Producers Association mails information to its members.

General Business Principles

A dairy cooperative should establish the same principles of successful business conduct as any other business. These questions are pertinent:

1. Is the management well qualified, efficient, and alert to changing conditions in the industry?

2. Is adequate managerial time set aside for systematic planning?

3. Does the cooperative have its future plans written, well organized, and adequately detailed?

4. Are future capital needs considered in the current budget?

5. Does the association have sufficient capital?

6. Are adequate records and accounts maintained?

7. Are regular audits made by qualified auditors?

8. Are unit costs low?

9. Is volume adequate—in terms of present facilities and in terms of present and prospective competition?

10. Is the business increasing or decreasing—in absolute terms and in relation to competition?

11. Have dependable sources of supply and dependable markets been developed?

Members and leaders of a cooperative may use these, and other questions they suggest, in self-analysis.

Special Needs of Cooperatives

Although a cooperative builds on the same foundation of business practices as any other business firm, differences in a cooperative's objectives necessitate some deviations in those practices. A cooperative has certain specific needs as a result of the relationship between the organization and its patrons, tracing through from its distinctive objectives. The general manager and



The cooperative way of doing business makes certain special types of records essential. This is the office of Lytton (Iowa) Cooperative Creamery.

procurement practices are particularly important.

The person who holds the position of general manager has much responsibility for the success of a cooperative. It behooves the membership, therefore, to evaluate his qualifications and performance carefully. Procurement practices, likewise, call for judicious appraisal to be sure they meet cooperative requirements. At times it may be tempting to sacrifice such requirements in order to capture the rewards of increased volume.

Cooperatives need several specific statistical and accounting records. These are so important that we suggest they be included in administrative criteria as well as employed in self-evaluation. The needs for these records will be discussed after our comments concerning the general manager and procurement practices.

General Manager.—Only a strong supporting membership contributes more to the success of a cooperative business than does a good manager. To be effective in a cooperative capacity, the manager, in addition to his general business

qualifications, must understand and be in sympathy with cooperative principles and methods.

These questions may be asked in evaluating a manager:

1. Does he think of and deal with patrons as members and owners to be served, or as mere suppliers of milk essential for the success of *his* business?

2. Is he in sympathy with the principle of democratic control by members, exercised through the board of directors?

3. Does he hold the confidence of directors and member-patrons and use their suggestions in formulating working policy?

4. Does he act on policy matters only after approval by the board?

5. Does he help develop progressive, constructive policies for the directors to consider?

6. Does he train personnel for supervisory positions so that they qualify from both the general business and cooperative points of view?

Positive answers to these questions indicate the kind of general manager who will work with the board and operate the business in a manner consistent with the interests of producer-patrons.

Procurement Practices.—Volume of business is as important to a cooperative as to any other type of dairy enterprise. Because of changes in technology and in market structure, the volume of milk which supported efficient processing and marketing operations in the past is no longer sufficient in most cases. Lack of volume has become a major problem to many cooperative plants.

Control of a sufficient volume of milk is likewise a major concern of cooperatives that sell milk by bargaining and operate no plants.

Without it they have little bargaining power.

While a dairy cooperative cannot serve the best interests of its patrons without sufficient volume, that volume should be sought in a manner consistent with the cooperative's need for a strong membership structure. It is, therefore, imperative to consider these questions:

1. Do all producer-members patronize the cooperative?

2. Do they patronize *only* because of price and service advantage or do they also realize that membership itself carries with it responsibility to patronize?

3. Do members lend support and build volume by soliciting new patrons and members?

4. Is nonmember patronage solicited and maintained on a purely competitive basis, or is it encouraged as a steppingstone on the way to membership?

5. Are the best interests of patrons bypassed in a competitive struggle for volume?

6. Do member-patrons sign marketing agreements or contracts setting forth their rights and duties and those of the association?

7. Do contracts or agreements obligate the member to patronize the association?

8. In the absence of a contract, are members obligated by the by-laws to be patrons of the association?

9. Are they aware of this obligation and reminded of it periodically?

10. Is the association a pace-maker or a follower?

11. Does it adopt new and improved practices and methods in its operations?

12. Has the association maintained high quality standards?

13. Does it assist its producer-patrons in improving the efficiency and quality of production on their farms?

14. Do returns in price, in service, and in equities merit members' support of the cooperative?

15. If the answer to the last question is negative, should the cooperative be permitted to disintegrate from lack of support, or should its competitive position be strengthened and its service to member-patrons continued by merger or other joint action with other marketing organizations?

Specialized Statistical and Accounting Records. — Cooperative methods of doing business require certain special records. This is particularly true in cooperatives carrying on integrated lines of operation and serving patrons who have unlike interests in the business. Cooperative methods of distributing net margins or operating balances also require special records.

A cooperative must maintain up-to-date membership rolls in a conveniently useable form. These are needed to conduct business meetings; in elections of directors and other officials; and in computing total member versus nonmember patronage and producer versus non-producer patronage. (See pp. 19, 20, and 21, "Producer Status and Patronage.") A dairy cooperative also needs accurate membership rolls if it wishes to vote for its members or to perform marketing services under the Federal milk marketing order program.

A cooperative that conducts elections or reaches any other business decision on the basis of districts or local divisions also needs records of the members assigned to each district. That is, if each district nominates or elects a director, the chair-

man of the meeting needs a record of the members eligible to vote.

It is true that elections and other business decisions are not often decided by a close vote and a close check of eligibility of members to vote may rarely be important. But it is very important to have the means of checking this eligibility should a decision be contested.

If any members have more than one vote, a cooperative must maintain a record of the number of votes to which each is entitled. This applies particularly to cooperatives that authorize voting in proportion to patronage.

Cooperatives should prepare an annual summary of their membership and voting rights. The following form is believed to include the information needed for completing most or all reports to members and to public agencies.

	Members	Num- ber of mem- bers	Num- ber of votes ¹
Farmers (including land- lords, tenants and farm- ing companies)		----	----
Farmer cooperatives		----	----
Other		----	----
Total		----	----

¹ To be filled out only if any members possess more than 1 vote each.

A farmer cooperative must maintain accurate and permanent records of the ownership of stock, revolving funds, and other equities. The need for these records is clear.

Accurate records of each individual's patronage are required to compute patronage dividends and also to compute member and non-member patronage. These must be accumulated and tabulated for each fiscal year. It seems prudent to preserve these records for at least 5 years in case any questions, misun-

derstandings, or lawsuits arise. A so-called "exempt" association should not destroy any records without approval of Internal Revenue Service.

Computation of total member and nonmember patronage calls principally for a correlation of membership rolls and patronage records. Some laws and administrative regulations currently make separate mention of patronage by farmers, business with the United States and its agencies, and patronage by other cooperatives. These requirements are entirely consistent with the various criteria of a farmer cooperative discussed in this report.

Essentially, they are all designed to help insure two of the major points we have emphasized: That the organization's purpose is to perform marketing service for its producer-patrons, and that it is controlled by producer-patron members.

A tabular form is needed to assure that data are available to report to members and to public agencies on the various categories of the business. The cooperative should record the following information:

Classification of business transacted during fiscal year ended _____, 19—

1. With or for members:

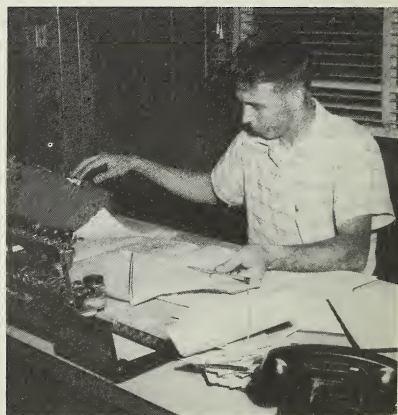
Farmers (including land-lords, tenants, and farming companies)-----	\$-----
Farmer cooperatives-----	-----
Other -----	-----
2. With or for nonmembers:

Farmers-----	-----
Farmer cooperatives-----	-----
United States or agency thereof -----	-----
Other -----	-----
 Total-----	 -----

(Business with holders of stock without voting rights is nonmember business.)

Accounting practices of a farmer cooperative should provide for separation of the returns and operating costs related to each major class of patronage wherever this is practicable. The cooperative idea of self-help requires separate accounting to groups of patrons with different interests. This problem is becoming increasingly severe. Many dairy cooperatives market two grades of milk. Some market milk and other farm products and have farm supply operations. There are numerous combinations. Present accounting practices force many cooperatives to essentially follow the market in returning marketing proceeds to patrons and other suppliers, or to be quite arbitrary.

The first priority may be for cooperatives with this problem to place all marketing patronage in one category, all purchasing of farm supplies in another category, and farm service operations in a third. Cooperatives with two or more separate marketing operations may find it advisable to subdivide those



Separate accounting for substantially different major classes of patronage is important to members and also provides a valuable tool to management.

operations, with separate departments for Grade A milk, manufacturing grade milk, eggs, and so on.

Member-patrons themselves should insist that their directors and general manager maintain separate accounting for substantially different major classes of patronage to the extent that classification is practicable.

The basic problem is how the cooperative may best achieve substantial equity in its treatment of different patrons. Theoretically, it should try to return to each patron the margins derived from marketing that patron's commodities. As a practical matter, achievement of that goal is impossible. Consequently, each cooperative should classify its patrons and their patronage to the extent that the costs do not become disproportionate to the benefits of the classification.²⁶

We recognize that such departmentalized accounting is complex and involves elements of judgment. For these reasons, separate accounting is not justified for low-volume departments where the amount of extra accounting detail is out of proportion to probable savings or usefulness of the records. The strongest argument for departmental accounting is its usefulness in management, rather than its necessity in demonstrating operations at cost.

Financial Practices.—The basic objectives of cooperative operations make investment of risk capital in

an individual cooperative unattractive to outside investors in most cases. When investors, rather than patrons, hold large amounts of risk or ownership capital, pressure may be exerted to abandon cooperative methods and objectives and to operate for the benefit of such investors instead of for the benefit of the patrons.

Articles or bylaws of all cooperatives should limit dividends on stock to a maximum of 8 percent a year; less if a lower maximum is set by State law. The Capper-Volstead Act and much other Federal and State legislation that follows its provisions make limited returns on capital an alternative to the one-man one-vote practice, instead of an absolute requirement.

We recommend that the principle of limited returns on capital be adopted by all farmer cooperatives to insure that they will provide their services to patrons at cost.

Members and their leaders may employ some additional questions concerning financial practices of their cooperatives.

1. Do patrons provide capital in proportion to the volume of their patronage? This question is especially important for equity capital on which the cooperative pays little or no dividends or interest.

2. Is the revolving fund method of financing used? This is certainly not the only sound financing method for cooperatives. But it is a suitable way, if properly administered, of providing for the proportionality described in point 1.

3. If a revolving fund is used, does the fund revolve? If not, why not? Does the failure to revolve result from investing the fund in fixed assets so that it is out of proportion to the annual net savings available to revolve it? Is

²⁶ *The Patronage Refund*, Notes, 35 Minn. Law Review 549, p. 558, May 1951.

"... it may not be practical to determine the returns on every commodity separately unless the volume handled or the difference in margins is great enough to warrant the additional labor and expense."

some permanent capital stock needed to supplement the revolving fund?

4. Have plans been made to provide the kinds and amounts of capital needed for expansion?

5. Are provisions made for retiring revolving fund credits or other ownership equities of nonpatrons?

6. What proportion of total ownership equities is held by nonpatrons? We have previously recommended that voting rights of nonpatron members be promptly terminated. It also is preferable, but not essential, to retire the equities of nonpatrons if their amount is large in proportion to the total. These may be converted into callable, dividend-paying, nonvoting shares of stock, if it is legally authorized.

Determinations by Public Administrators

As we have noted frequently, many of the preceding standards for identifying a dairy cooperative can be used by public administrators as well as by a cooperative for internal appraisal. We have identified 11 criteria that are sufficiently specific and important for potential use by public administrators, and are listed separately in the conclusions. But several of these itemized criteria require some interpretation in their application.

The public administrator faces a difficult task in applying standards that require the exercise of judgment. This difficulty becomes apparent in considering, for example, how to identify the individuals served by an organization being appraised for its cooperative features and those who control it. The administrator in our system of gov-

ernment is limited to applying, with the necessary interpretation, his legislative authorizations. He must be on constant guard to explain and defend his actions. It is difficult to include in legislation criteria which will fully take the place of judgment.

It is recognized that legislation authorizing certain programs may need clarification as times change in order to assist administrators of those programs in exercising judgment when applying legislative standards. It also may assist program administrators, if the legislation directly states their authority and responsibility to develop and apply necessary criteria for identification of organizations qualified to obtain the rights reserved for cooperatives.

No Permanent Criteria

While we have outlined numerous criteria and guides to cooperative character of dairy organizations, we make no claim that these are either complete or permanent.

Other business practices and policies than those presented also reflect the ability of an organization to serve its patrons and to adjust without erosion of its cooperative character. As a dairy cooperative expands its services, it will need to make changes in its business and operating methods.

Accepted ideas of cooperative character are likewise subject to change. It is imperative, however, that each proposed change be considered from the standpoint of its contribution to the cooperative's prime objective. That objective is for producers to serve their own best economic interests through marketing under their own control.

Cooperatives and Federal Orders

SINCE the end of World War II, an increasing number of cooperatives marketing fluid milk have turned to Federal milk marketing orders for assistance. In 1960, over 43 percent of all milk sold by dairy farmers to plants and dealers in the continental United States was priced under Federal orders.

Early Development

Federal orders entered the milk marketing picture in the 1930's as a means of establishing more orderly marketing conditions and higher prices. Before that time fluid milk marketing cooperatives had developed and were using classified pricing plans with varying degrees of success.

The Federal milk marketing order program was established under the Agricultural Marketing Agreement Act of 1937. This program attacked the problem by providing an industry pricing plan, similar to that previously attempted by the cooperatives. It differed mainly in

that: (1) Minimum prices applied to all handlers on all milk eligible for fluid usage in the market; and (2) the order was enforceable by law. Prices bargained for by cooperatives acting independently had applied only to their patrons' milk and depended upon the bargaining strength of the cooperative for enforcement.

The principal procedures incorporated in Federal order programs are:

1. A marketing area is defined within which the handling of milk will be regulated.

2. Milk is classified in accordance with the purpose for which it is used.

3. A minimum price to producers is fixed for each classification of milk use.

4. The minimum price is the same to all handlers.

5. Milk is pooled either on a marketwide or individual handler basis.

6. An agency is provided to administer the order.



Cooperatives provide professional representation for their members at Federal milk marketing order hearings.

These mechanisms and procedures improved the orderliness and stability of marketing and, in many cases, brought direct price increases.

The Secretary of Agriculture is directed to employ a hearing procedure to obtain the facts used in establishing Federal orders and their terms.

The details of how Federal orders are established and how they operate are not directly pertinent to the subject under discussion here. It is important, however, that we consider the significance of the Federal orders from the standpoint of cooperative participation.

Role of Cooperatives

Federal orders do not replace dairy cooperatives as representatives of producers in marketing milk. On the contrary, those administratively responsible for the program at the national level have always recognized the necessity of continued cooperative endeavor in effective Federal order operation. Congress acknowledged this in passing the 1937 act by providing for the rights of cooperatives operating in Federal order markets.

H. L. Forest, Director of the Milk Marketing Orders Division of the Agricultural Stabilization and Conservation Service, is directly responsible for administering the milk orders. He expressed this view in a 1959 speech, when he was Director of the Dairy Division of Agricultural Marketing Service:

Farmers must take an active part in building the records on which marketing orders are drawn. They can do this effectively only through their cooperatives, which enable them to employ the assistance of trained specialists to analyze the market problems from the producers' point of view.

Only through cooperative marketing associations can producers develop and provide the kind of expert leadership and professional service required for effectively presenting the needs of producers and supplying all the necessary information concerning the producers' side of the market. Such information is indispensable to the formulation of a market price program.²⁷

This statement emphasizes the important role the cooperative plays in pricing milk under a Federal order. In a regulated market, minimum prices are established by the order—not by negotiation between the cooperative and the handlers. The terms of the order, however, depend largely on the effectiveness of the cooperative and of milk distributors in presenting data at order hearings.

This change in the method of price determination is the principal effect of an order on the functioning of a cooperative. In most other respects the milk marketing cooperative functions as before. It still has to find a market for its patrons' milk and provide for transportation, storage, and processing. Supplies must still be procured. In short, the Federal order is a pricing mechanism—not a general marketing service. Furthermore, order prices are minimums and in many cases cooperatives obtain higher prices by bargaining with handlers.

As previously indicated, certain pre-existing practices of cooperatives are specifically recognized as rights under terms of the 1937 act. These are, principally, the right: (1) To vote on behalf of its producers, (2) to pool returns, and (3)

²⁷ Forest, H. L. *Responsibilities of Farmer Cooperatives, Distributors and Government In Relation To Federal Milk Orders*. Mimeo address, p. 4, Agricultural Industries Forum, Univ. of Ill., Urbana, January 1959.

to provide specified services for its producers that otherwise would be performed by the Market Administrator.²⁸

The language of the Agricultural Marketing Agreement Act recognizes that these and similar functions existed before the act. Regarding pooling, the act says, "Nothing . . . shall . . . prevent" Regarding marketing services, services provided by a cooperative are, in effect, given precedence over those of the Market Administrator. The voting provision merely makes explicit the agency status of the association.²⁹

The act specifies the proportion of producers required to approve issuance of an order. Likewise producers may request and obtain termination of an order. In either case, approval or disapproval of a qualified cooperative is considered as the approval or disapproval of its producers. A qualified cooperative may blend its net proceeds from all sources and pay its producers in accordance with the contract between the association and its producers.

Producers are provided various services, including collection and dissemination of market information, check weighing, sampling and testing of milk, through the Order Administrator's office. A direct charge is made for these services against producers receiving them. Producers patronizing a cooperative are exempt from this charge, however, if the association is qualified and performs the service.

Qualifications Under Federal Milk Orders

The act of 1937 specifies that cooperatives performing the functions discussed in the preceding section must meet certain minimum qualifications. The qualifications are not identical for each of the rights. However, as an administrative official of the program said in 1938, ". . . it was undoubtedly the intent of Congress to encourage only bona fide producer-owned and producer-controlled cooperatives."³⁰

To encourage only "bona fide" cooperatives and to achieve the purposes of the act, those responsible for administering the Federal milk marketing orders have developed broad criteria for judging associations' applications for qualification as cooperatives in federally regulated markets.

Two separate qualifications usually must be established. First, the cooperative must be qualified to vote for its producers in accordance with the terms of the act of 1937. Second, it usually must be qualified as a producer cooperative under the terms of the specific marketing order, and applicable provisions of the act.

The following criteria have been considered by departmental staff in determining whether recognition of an association should be recommended to the Secretary of Agriculture:

1. Is the association producer owned and producer controlled?
2. Is it operated for the mutual benefit of its producers?

²⁸ ". . . the producers who are members of, stockholders in, or under contract with, such cooperative association of producers." 7 U.S.C. 608c(12).

²⁹ 7 U.S.C. 608c (5) (E, F), and (12).

³⁰ Gaumnitz, E. W. *Effect of Federal Milk Control on Cooperatives*. Mimeo address, p. 5, Annual Convention of the National Milk Producers' Federation, Cincinnati, Ohio, November 1938.

3. Does it conform to the requirements of the Capper-Volstead Act as to either voting or dividends, and, in any case, as to dealing in the products of nonmember-patrons?

4. Is it contractually authorized to market its producers' milk and does it actually make use of this authorization?

Details of the interpretation and application of these criteria are not within the scope of this study.

If cooperatives have been qualified for voting and do not sell milk to regulated handlers at prices less than those fixed pursuant to the order, they can expect recognition for pooling milk and paying their patrons according to contract. In addition, their independent programs for check testing, verification of milk weights, and providing market information to producers will be recognized if they have actually performed these services in a satisfactory manner.

The responsibility of administrative officials does not end when eligibility is determined and a cooperative is accepted as qualified under an order. Encouragement of "only bona fide cooperatives" necessitates regular appraisals to assure that associations previously quali-

fied under the order retain their cooperative character, continue to be controlled by and operated in the interests of the producer-patrons, and continue to provide specified services at acceptable levels.

Experience has indicated that considerable caution is necessary to avoid qualification, and thus encouragement, of organizations incorporated as cooperatives and controlled on paper by producer-patrons, but actually dominated by other than active producer interests. Such organizations obviously are not likely to adequately represent producer interests in Federal order marketing operations. Detection of such outside controlling interests is not always easy. A well-informed and alert membership is probably the best first line of defense against such a development in a cooperative.

The administrative criteria employed by the Secretary of Agriculture in identifying cooperatives for functions relating to the Federal milk marketing orders—briefly outlined in this section—are the second line of defense. Careful administration is necessary to avoid granting an organization rights that are not compatible with its true character.

Conclusions

THIS study was undertaken specifically to provide criteria for distinguishing between a real (bona fide) and an imitation (pseudo) cooperative. Eleven specific criteria have been discussed and will be listed again in this section. Some of these require a high level of judgment and interpretation in

their application. Statistical data and clerical skills alone will not provide a reliable appraisal of a particular organization as a farmer cooperative engaged in dairy marketing.

Our research, however, strongly indicated the need for some subjective standards, as well as the 11



Directors and other members should periodically evaluate their cooperative to be sure that it is serving their needs and following cooperative principles.

itemized criteria, for appraisal of a dairy organization. The section "Determining Cooperative Character" includes several series of questions and standards. These additional questions are not intended for direct application by State or Federal administrative agencies.

The 11 itemized criteria themselves require the exercise of considerable judgment and cannot be applied on an entirely objective and categorical basis. It does not seem possible to determine such conditions as control by producer-patrons and the performance of marketing services for members without some exercise of judgment. Clear legislative direction and careful administrative planning are both needed to provide for an orderly administration of criteria involving judgment.

Our research also emphasized that member-patrons, or prospective member-patrons, should make their own appraisal of an organization. The nature of a cooperative requires that they do so. Such ap-

praisers can apply the more subjective standards and guides presented, plus others of their own choosing.

Criteria for identifying a farmer cooperative must be grounded on legal and economic concepts. Social values cannot be escaped, however, and may be interpreted as even more basic. Social values are quite evident, for example, in cooperatives' voting and pooling practices.

The economic and legal concepts are necessary to identify the essential differences of organization or objectives that set apart a farmer cooperative. But an entirely opportunistic approach, based either on business success alone or farmer control alone, is of little value. Such an approach would permit the idea of a farmer cooperative gradually to merge with the objectives, forms, and operating practices of other business enterprises or with organizations that are not specifically economic in character.

We identified three underlying "hard core" principles of farmer

cooperatives which have remained relatively fixed:

1. Service to members at cost.
2. Democratic control by members.
3. Limited returns on capital.

Cooperatives differ substantially from other types of business in each of these respects.

We then turned our attention to developing standards for identifying an actual cooperative on the basis of these principles. Both specific, itemized criteria and supplemental questions (principally for internal appraisal) were presented and discussed. These criteria and questions were designed to provide positive answers to three questions:

1. Is the cooperative performing marketing services for members in their best interests?

2. Is the cooperative organized so that producer-patrons control it now and will control it in the future?

3. Is the business of the cooperative conducted in accordance with sound business methods which will assure its continuing ability to provide services to producer-patrons at cost?

It may be extremely difficult in some cases to decide whether an organization is performing marketing services. Agreements with patrons that give the organization marketing authority are a good way to strengthen the evidence that this service is being performed.

Patrons, at least, also want to evaluate whether a cooperative is performing the particular services it should to meet their needs. This is important in helping adjust to changing marketing conditions.

Cooperative leaders and writers have devoted much attention to the problem of "captive" organizations in discussions of the administrative

identification of dairy cooperatives. This brings up the question of determining control by producer-patron members. Identification of those who have voting rights in the cooperative is fundamental, but does not, in itself, provide an answer that producers or administrators of some State or Federal programs may wish, or be authorized, to accept as complete. There may be improper outside influence or control even when voting rights rest solidly with current producer-patron members. A thorough analysis may be required to identify such influence.

An interested and informed membership can prevent loss of member-control in a cooperative. Regrettably, interest and degree of understanding are difficult to measure. These, therefore, become objectives to pursue, rather than categorical standards of measurement. The cooperative's communications with its members are thus vital in maintaining member-control.

Sound business practices are as vital in a cooperative as in any other concern. The general business methods of a cooperative are essentially the same as business management everywhere. There is, however, a specialized area of cooperative business methods that requires careful attention.

Cooperative business methods require keeping certain specialized records. These provide evidence of voting rights, equities, patronage, and the basis for computing returns to different patrons and classes of patrons.

The general manager of a cooperative should be an effective business manager and also be in sympathy with cooperative methods and objectives. He must work to strengthen the association's distinc-

tive cooperative character. Surely this combination of competency and interests is most difficult to appraise.

We have spelled out the criteria that we consider both specific and important. These criteria may be considered by State and Federal agencies in identifying cooperatives engaged in dairy marketing and adapted as required to meet the needs of their specific programs. They may also be employed by members and patrons themselves and by their leaders in appraising a particular cooperative.

These specific criteria, which were discussed earlier in this report, are listed again here:

Suggested Criteria for Identifying Farmer Cooperatives Engaged in Dairy Marketing

1. The cooperative ordinarily should be incorporated under the cooperative corporation laws of a State or an equivalent statute. (p. 7)

2. The cooperative must be engaged in marketing dairy products by doing one of three things:

a. Purchasing and selling milk with title passing to and from the cooperative; or

b. Marketing milk as agent of the producer-patrons under terms of a contractual agreement (with or without the cooperative taking title); or

c. Physically receiving the milk involved in its marketing operations. Physical handling alone may not be an adequate test for some purposes. (pp. 14-15)

3. A minimum of 50 percent of the organization's marketing patronage, based on raw product quantity or value, should be with the products of member-producers. (p. 16)

4. Products marketed for non-producer-patrons (that is, others than individual producer-patrons and other farmer cooperatives) should not exceed 10 percent of the raw product quantity or value of all products marketed. Exceptions may be made in individual instances because of particular trade customs, temporary situations following acquisitions, and temporary outside use of facilities maintained for anticipated future needs in marketing members' products. (pp. 16-17)

5. Membership should be limited to producers who patronize the cooperative by marketing their milk and dairy products through it or by using its other marketing or purchasing services. Memberships should be terminated promptly whenever a member either ceases to be a producer or fails to patronize the association for 12 months. Total crop failure or other unusual circumstances may require individual exceptions to this requirement. (pp. 21-22)

6. Voting rights of members should be either on the basis of—

a. One-man one-vote, or

b. In proportion to patronage (either with or without a limit).

Laws in some States permit only the one-man one-vote practice. In others, more than one voting share of stock may be issued to an individual member. Cooperatives may follow this practice if it is accepted in their States. In such cases, however, special attention must be directed toward other indications of control by producer-patrons and of operation at cost. (pp. 23-24)

7. No director or managerial employee should own stock, be employed by, or receive any compensation from any other dairy in the operating area. Similar conflict-of-interest policies should apply in

other marketing or purchasing departments of the cooperative. (p. 24)

8. Directors and the general manager should not enter into contracts or other business arrangements that place outside interests in the position of dictating association policies. Sales and management contracts should be examined for any conflicts of interest or any commitments not essential to giving adequate service to buyers. (p. 25)

9. The cooperative should not be indebted to its buyers. Any borrowing from buyers should be specifically authorized by the board of directors as being required by exceptional circumstances. Care should be exercised in determining that the cooperative's policies are not unduly influenced as a result of this debt. (p. 25)

10. Bylaws should limit returns on all capital stock, membership capital, and other equities to no more than 8 percent a year, or less, if a lower maximum is set by State law. (p. 33)

11. Statistical and accounting records should be appropriate for the needs of farmer cooperatives. They should include—

a. An up-to-date membership roll in a conveniently useable form. If any member is legally entitled to more than one vote, the number of votes of each must be shown on a record available for use at each

business meeting. (p. 31)

b. Accurate and permanent records of stock ownership, revolving fund, and other equities. (p. 31)

c. For computation of patronage dividends, accurate records of patronage must be kept each year. Sound custodianship requires that these records be preserved for at least 5 years. A so-called "exempt" cooperative should not destroy any records without approval by Internal Revenue Service.

Records must provide for accurate computation of total member and nonmember patronage. In practice, patronage of farmers and other farmer cooperatives, and business transacted with or for the United States and its agencies, and other nonpatrons also should be identified and tabulated separately in both the member and nonmember categories. (pp. 31-32)

d. Accounting practices should provide for separation of the returns and operating costs related to each distinctly separate major category of patronage. The first priority may be separation of records of marketing, farm supplies, and farm services operations. Cooperatives marketing two or more specific products, such as Grade A milk, manufacturing grade milk, cream, eggs, and so on, may also find it advisable to set up individual accounts for these products. (pp. 32-33)

Other FCS Publications Available

- The Story of Farmers' Cooperatives. Educational Circular 1.
Organizing a Farmer Cooperative. Circular 18, Revised.
Farmer Cooperatives in the United States. Bulletin 1.
Financing Farmer Cooperatives. Educational Circular 5.
Directors of Regional Farmer Cooperatives—Selection, Duties, Qualifications, Performance. General Report 83. *David Volkin, Nelda Griffin, and Helim H. Hulbert.*
Management Training Among Farmer Cooperatives. General Report 65. *David Volkin and Nelda Griffin.*
Making the Most of Your Co-op Annual Meeting. Circular 22. *Oscar R. LeBeau and French M. Hyre.*
Membership Practices of Local Cooperatives. General Report 81, *Oscar R. LeBeau.*
Planned Public Relations in Modern Cooperative Business. Information 10. *Martin A. Abrahamsen.*
Integrated Dairy Operations Through Farmer Cooperatives. General Report 69. *Anne L. Gessner.*
Seasonal Milk Pricing Plans. Bulletin 12. *Stanley F. Krause.*
Multiquart Containers—Their Effect on Milk Packaging and Handling Costs in Selected Cooperatives. General Report 90. *William J. Monroe.*
How Manufacturing Co-ops Market Grade A Milk. Circular 26. *Donald R. Davidson.*
Selecting a Program for Butterfat Sampling. Circular 11. *Homer J. Preston.*
Milk Receiving Costs During Shift From Can to Bulk. General Report 77. *James B. Roof.*

A copy of each of these publications may be obtained upon request while a supply is available from—

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